Banking Crisis Update

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The Fed has caused a banking crisis nearly every time it whipsaws interest rates. Look at the late 70's and early 80's where we lost a third of all savings and loan associations. Or how about the Great Panic of 08 and 09 when Bear Stearns, Washington Mutual, IndyMac and Lehman Brothers went under? From 2008 to 2010, 322 banks with $639 billion in assets went under. By comparison, SVB had $210 billion, First Republic had about $229 billion and Signature Bank had $110 billion[1]. The failures of 2008 and 2009 represented roughly 6% of overall U.S. banking assets compared with 2.3% this year. Everyone wants to know why these banks went under and if more pain lies ahead for the financial sector.

In the last crisis, large banks received a federal bailout known as "TARP." Wells Fargo received $25 billion, Bank of America received $15 billion, JP Morgan received $25 billion, Citigroup received $25 billion, Morgan Stanley and Goldman Sachs received $10 billion each. Merrill Lynch and Morgan Stanley both nearly went under and needed to be rescued[2]. As a result, government picking of winners and losers has made the "Too Big to Fail" even bigger this time around. While popular opinion suggests banks went under in 2008 and 2009 because of aggressive mortgage lending, there's more to the story. For years, politicians from both parties incentivized banks to make loans to people with questionable balance sheets. Further, when the crisis did happen, a mark-to-market accounting rule took a small mortgage-backed security problem and made it worse. While individual facts and circumstances were slightly different in the S&L Crisis, the Great Panic, and our current banking crisis, the Fed was aggressively hiking rates in each environment[3].

Silicon Valley Bank (SVB) – SVB failed because it broke the cardinal rule of banking…never buy long term bonds[4]. When rates go up, bond prices go down. The longer term the bond, the harder it falls as rates rise. When the Fed cut rates to near zero in 2020, SVB bought 30-year bonds that paid 1.5% of interest or less. Losses rose significantly when the Fed raised rates from zero to 5%. SVB should have never touched long term debt (like we warned clients) and at a minimum, hedged duration risk. With mostly uninsured deposits, a run happened nearly instantly causing the bank to go under in a matter of weeks.

Signature Bank – Similar to SVB, Signature had a high ratio of uninsured deposits[5]. While a lot of the issues can be blamed on management's fault, it can't be overstated how much the Fed contributed to the bank's failure with insane money printing policy in 2020. The Fed printed 45% more dollars into the economy and Signature's deposits rose 64%. They expected these assets to remain, not realizing the chickens would eventually come home to roost, sending deposits back down to normalized levels. Again, we've been warning of this for over two years, reminding our clients to be cautious with unnecessary spending and the importance of paying down debt. Signature was partially management's fault, partially the Fed.

First Republic – Mostly their own fault, First Republic engaged in overly aggressive lending and advisor recruiting practices[6]. At the peak, First Republic was paying financial advisor teams nearly five times their revenue to migrate to the bank. While not the only contributor to the bank's collapse, advisor buyouts at 5x are largely unprofitable as interest rates go from zero to 5%. The bigger contribution, aggressive lending practices, is what ultimately made First Republic fail. The bank was paying 0.01% interest on customer deposits in investment accounts and making ridiculous long-term loans at 2% interest rates. When rates rose, customers demanded higher rates and started pulling deposits out of the bank. Over the course of a few months, the bank was forced to either pay customers prevailing interest rates at a major loss or risk further deposit outflows.

Where do we go from here? We expect more regional banks to disappear over the next few months. Remember, this is still the wilderness where no one really knows the true long-term ramifications of the Fed's COVID response. For investors on a diversified long-term plan, now is a great time to buy some great companies for dirt cheap prices. In a few years, the current crisis will be a blip on the radar and we'll be on to the next media doom and gloom story.

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